



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Dave Sykes
Kim Walesh

SUBJECT: SEE BELOW

DATE: April 1, 2014

Approved

Date

4/1/14

COUNCIL DISTRICT: 3

**SUBJECT: LEASE OF CITY HALL PROPERTY TO FEDERAL GOVERNMENT
FOR REGIONAL PATENT AND TRADEMARK OFFICE**

RECOMMENDATION

- 1) Conduct a public hearing regarding an economic development subsidy in connection with a below-market-rate lease with the U.S. Government, pursuant to California Government Code Section 53083; and
- 2) Adopt a resolution authorizing the City Manager or his designee to negotiate and execute a below-market-rate lease with the U.S. Government for the operation of a regional patent and trademark office to be located in approximately 35,194 square feet of space in the City Hall Wing.

OUTCOME

Approval will enable establishment of a regional satellite office of the U.S. Patent and Trademark Office (USPTO) in Downtown San José, which will help entrepreneurs in the region more readily navigate the nation's intellectual property system. Establishing the office in Downtown San José will bring other public benefits to the local area, including increased business visitors and the location of related firms seeking proximity to the USPTO.

BACKGROUND

The America Invents Act, signed into law by President Obama in September 2011, called for the United States Patent and Trademark Office (USPTO) to establish three or more satellite offices. The goal was to improve the speed of the patent application process and draw new talent to the office so that more entrepreneurs can protect their intellectual property in a timely manner, which is critical to attract capital and create jobs.

Along with others nationally, private and public leaders from San José/Silicon Valley contributed significant effort to defining and encouraging this step. Carl Guardino of the Silicon

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Valley Leadership Group, San José Mayor Chuck Reed, Congresswoman Zoe Lofgren and the region's Congressional delegation, and President Mo Qayoumi of SJSU were strong advocates of this approach.

USPTO opened its first satellite office in Detroit in July 2012 and has plans to open offices in Dallas and Denver, which will be located in existing federal office buildings.

In January of 2013, the Federal General Services Agency (GSA) launched a search for private office space (35,000-40,000 square feet) in the "delineated area" between San José and Mountain View to lease on behalf of the USPTO. Several San José-based building owners expressed interest and the City continued making a strong case that San José uniquely met the GSA's location specifications, which included walking distance to public transit and a variety of restaurants and services nearby.

In April 2013, the USPTO began operating with ten employees out of temporary office space in Menlo Park that had been secured by the GSA. In July 2013, the search for permanent office space was put on hold due to the Federal budget sequestration.

The City's interest in offering City Hall space at a savings off of the market lease rate enabled the USPTO to restart its plans to open a permanent office in the Silicon Valley while securing the location of the USPTO satellite office in Downtown San José. On November 19, 2013, the USPTO announced that they had selected San José City Hall as the location for the Silicon Valley Patent Office.

ANALYSIS

Significant Win for Downtown San José, Significant Public Benefits

Securing the Patent Office is a very significant win for San José, an important new asset and anchor institution for Downtown, and will bring significant public benefits.

The City Hall location will provide office space for Patent Examiners and for Patent Trial and Appeal Board (PTAB) Judges. It will include public hearing rooms for PTAB proceedings and a robust patent examiner training facility. In specially designed community outreach space, small businesses and entrepreneurs will be able to learn about USPTO services, meet with patent examiners, and access USPTO's comprehensive search databases. The space will provide public access to search equipment and teleconferencing capabilities to facilitate virtual meetings with offsite Patent Examiners.

Offering USPTO a lease with a below-market rate component made the difference in USPTO committing to locate the office in Downtown San José. The alternative would have been, after the sequester ended, restarting a lengthy search by the GSA for market-rate private space located somewhere in the large delineated area identified between San José and Mountain View. This would have had an uncertain outcome with regard to final location.

Having the USPTO locate in Downtown San José will bring the following public benefits:

- a) ***Better Access to USPTO, Accelerated Patent Processing***— The USPTO space will allow regional entrepreneurs to more readily navigate the nation's intellectual property system, ultimately helping to speed up products getting to market and job growth. Companies and entrepreneurs in Silicon Valley, and especially those located in San José, will have convenient access to the staff and resources of the USPTO located Downtown. The additional examiner capacity will help expedite the patent review process and reduce the current backlog. A robust public-facing outreach center will provide additional benefits to the region through education and assistance services on intellectual property.
- b) ***New Jobs***— Anticipated employment includes 80 patent examiners, 20 administrative judges, and management, administrative and IT staff totaling approximately 110 positions. Most of these will be newly created positions and most are anticipated to be hired locally (rather than transfers from other USPTO locations). These new hires are expected to include mid-career people with engineering, science, or technical backgrounds as well as recent college grads. USPTO is partnering with work2future and SJSU to hire people from the local market.
- c) ***Additional Leases Nearby***—The presence of the USPTO will likely attract follow-on economic growth through the gravitational pull that a USPTO office has on law firms, search firms, and retailers seeking geographical proximity to the world's most trafficked intellectual property system. The City Hall location is expected to attract other businesses and nonprofits related to intellectual property to locate nearby because they want convenient and regular access to USPTO.
- d) ***New Business Visitors***—The USPTO will attract business visitors to Downtown San José and their associated spending on parking and meals.
- e) ***Prestige and Identity***—The USPTO is a high-profile 'win' that brings prestige to San José. The location decision reinforces San José's identity as the Capital of Silicon Valley and Downtown's role as Silicon Valley's city center. The City of San José is the #1 patent-producing city in nation.
- f) ***Facility Investment***—As part of their tenant improvement package, the USPTO will invest in bringing the previously unfinished '4th Street Retail Space' from 'cold shell' to finished status. The estimated value of this improvement is greater than \$1,000,000 and may be of value to the City upon lease expiration.

USPTO Location on the City Hall Campus

USPTO and City staff spent considerable effort identifying the specific location on the City Hall campus that is best for both parties. USPTO and the Administration agree that the best location within City Hall Campus is the 4th Street Retail Space which is currently vacant and undeveloped, all of the 2nd floor of the Wing, and a portion of the 3rd floor of the Wing (fronting 4th Street). This location is the most desirable for the cohesion, visibility, accessibility and security of both parties.

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The estimated cost of the project design and construction for this space is approximately \$6.0 million, which will be paid by USPTO.

Relocation of City Employees

Locating the USPTO on the City Hall campus will require relocating six City units that currently reside in the Wing. The City Clerk, currently located on the second floor of the Wing, is proposed to be moved to the third floor of the Wing. The IT staff, currently housed on the third floor of the Wing, will be moved to the 11th floor of the Tower where IT is currently located. Three units will be moved from the Wing to the City Hall Tower: City Auditor, Human Resources, and Office of Employee Relations. Police Gaming Control will move either to the Tower or another Wing or Fourth Street location.

There is sufficient vacant space in the City Hall Tower to accommodate the proposed move, which also provides opportunity for more efficient use of space and better collaboration among City staff. Staff conducted a space survey of the Tower and identified at least 36,000 square feet of vacant space. They are further studying 30,000 square feet which may not be needed for business purposes. These areas may be currently used as storage, may be obsolete, or consist of space that is poorly planned. The two floors in the Tower that have the largest vacancies are the 4th floor and the 14th floor. These floors are the primary focus of potential spaces for the business units that will move, but all areas with vacant space will be considered.

The estimated cost of the design, construction, and relocation of City employees is approximately \$4.66 million. This expense will be covered by rent received from USPTO during the first five years of the lease. The lease will contain language that requires the USPTO to continue to pay the City rent through Year 5 even if they vacate the leased area prior to that time.

Project Management and Schedule

USPTO has requested and will pay for the City to manage the design-build project, with joint procurement of design/build services for both the USPTO office and the City employee relocation. USPTO is eager to open the office in San José as soon as possible, and both City staff and USPTO staff have worked to develop an aggressive project delivery schedule. Delivering these projects jointly will allow the City to meet the USPTO's schedule.

On May 6, 2014, staff will be submitting for Council consideration approval of findings for an expedited Design/Build Procurement process and the form of the Request for Proposal. It is anticipated that the Design/Build contract would be presented for Council consideration on August 5, 2014.

City offices are scheduled to move from the Wing to the Tower between March and May of 2015. The USPTO leased area is scheduled to be completed in phases starting in May 2015 and completing in July 2015.

Lease Terms

The USPTO and City have negotiated the following major lease terms:

1. Lease approximately 35,194 square feet of space.
2. Market rental rate for Years 1-5 (with annual 2.9% COLA adjustment).
3. "50% off" market rental rate for Years 6-10 (with COLA).
4. Starting rental rate of \$2.23 per foot per month, which includes facility rental at \$2.00sqft and \$.23sqft for utilities, maintenance and repair services.
5. Initial lease term is five years, followed by 15 one-year extension options. USPTO may terminate during the initial term with prior notice, provided they continue to pay facility rental through the remainder of the initial term. The extension options in Years 6-10 will be at the sole discretion of the USPTO. Extension into Years 11-20 will require City concurrence.
6. Market rental rate for extensions into Years 11-20 would be re-set prior to Year 11, and subject to annual COLA adjustments for later years.
7. USPTO is responsible for custodial and security costs.
8. City is responsible for utilities (except telecomm) and for maintenance and repairs.
9. USPTO's support for employee parking and transit will be independent of the City.

Private Activity Test

The Internal Revenue Code (Code) restricts the City's ability to lease facilities that have been constructed or improved with tax-exempt debt. These are referred to as the *private activity rules*. The penalty for violation of the private activity rules is loss of the tax-exempt status of the bonds.

In general, when a facility has been financed with tax-exempt debt, there is a limit on a private party's use of the facility in the course of their trade or business. The USPTO is a department of the Federal government and, as such, does not constitute a state or political subdivision under the Code; it therefore must be treated as a private party. A lease of a portion of the City Hall to the USPTO constitutes a private business use of that portion of City Hall and rental payment by the USPTO to the City will constitute private payments with respect to the bonds.

There are two parts of the private activity test: private business use and private security or payment. The Code provides that if a bond issue meets *both* the private business use test and the private security or payment test (collectively the "Private Business Tests"), the bonds will be considered private activity bonds and be subject to the loss of their tax-exempt status. The private business use test is met if 10% of the bonds expended on the facility to be used by the private party if it is related and not disproportional, and 5% if it is unrelated or disproportional. Similarly, the private security or payment test is met if the payments from the private user equal payment of debt service on more than 10 percent of the debt service on the bonds (5 percent in the case of unrelated or disproportionate use). The Code and IRS regulations provide complicated requirements on how the private business use and private security/payment tests are calculated.

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Since there was no specific IRS guidance on whether the IRS would view the USPTO's work as related to the City's operations at City Hall, the analysis prepared by the Finance Department in consultation with the City Attorney's Office and bond counsel used the 5% limit.

The Code also provides that if a bond issue does not meet the Private Business Tests due to not meeting the 5% or 10% thresholds, but the private business use or private payments actually exceed \$15,000,000, then this excess is treated as an "Excess Nonqualified Amount" and the bond issue will also be at risk of losing its tax exempt status. The Code specifies that the Excess Nonqualified Amount is the lesser of (i) the amount that the private business use exceeds \$15,000,000 or (ii) the amount that the private security/payment exceeds \$15,000,000. Having an Excess Nonqualified amount could cause the interest with respect to the Bond issued to finance and refinance City Hall to lose their tax exempt status.

The Finance Department working with the City Attorney's Office and outside bond counsel prepared a private activity analysis based on the information provided by the Public Works Department on the construction costs for various components of the City Hall construction (Tower, Wing, Rotunda, Garage and Plaza), the total City Hall construction cost, and the gross square footage to be leased to the USPTO over a 10-year and 20-year lease period. Additionally, private activity analysis included other private uses over the occupancy of the building.

Taking into account the existing private business uses and future expectation of a 20-year lease of the Wing space to the USPTO, total private business use of City Hall is under the 5% private business use limitation and as result the private business use test has not been met. As both parts of the Private Business Tests (private use and private security/payment) must be met in order to violate the private activity restrictions, it does not matter if the private security/payment test is met.

Staff also analyzed whether the \$15,000,000 Excess Nonqualified Amount would be reached. Based on information available, the amount of the existing and proposed private uses is less than \$15,000,000. Since the dollar amount of the private uses is less than \$15 million, then, even if private payments exceed \$15 million, these payments are ignored because the nonqualified amount is computed based on the lesser private business use. Accordingly, there is no Excess Nonqualified Amount.

In summary, the analysis demonstrates that the City can proceed with the lease terms outlined in this memorandum with the USPTO; however, it is important to note that the lease of 35,194 square feet of City Hall space to the USPTO eliminates any other significant private activity use in City Hall until the bonds are paid off in 2039.

COST SUMMARY/IMPLICATIONS

The chart below describes the lease revenue, City employee relocation costs, and City-provided maintenance services over the potential 20-year period.

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	Years 1-5	Years 6-10	Years 11-20	TOTAL
Revenue				
Projected Lease Revenue	\$4,961,115	\$3,067,238	\$13,438,025	\$21,466,378
Expenses				
City-Provided Maintenance	\$295,630	\$295,630	\$591,260	\$1,182,520
Cost of Relocating City Employees	\$4,660,326	\$-0-	\$-0-	\$4,660,326
Total Expenses	\$4,955,956	\$295,630	\$591,260	\$5,842,846
Net	\$5,159	\$2,771,608	\$12,846,765	\$15,623,532

Lease revenue of nearly \$5.0 million is projected from the USPTO in years one through five. This figure is expected to drop to \$3.1 million in years six through ten and then increase to \$13.4 million in years 11 through 20. Over a twenty year period, \$21.5 million in lease revenue is projected.

On an ongoing basis, maintenance costs of approximately \$59,000 annually will be incurred by the City's General Fund. These ongoing costs will be factored into the annual budget. The City will incur one-time General Fund costs estimated at \$4.66 million associated with the relocation of City staff. Of this amount, \$200,000 was allocated as part of the 2013-2014 Mid-Year Budget Review to support the initial work on this project. It is anticipated that the remaining one-time funds will be included as part of the 2014-2015 Proposed Budget.

In the first five years, the lease revenue from USPTO will be sufficient to offset the relocation costs and maintenance costs. After the first five years, and into years 11-20, the lease payments will cover the maintenance costs and generate net revenue. Over a 20-year period, the estimated lease revenue of \$21.5 million is \$15.6 million above the estimated costs of \$5.8 million.

The USPTO will be responsible for the design and construction costs associated with its move into the Wing; their costs are estimated at \$6.0 million.

While not a net increase in cost to the overall City budget, the location of the USPTO in the Wing and subsequent relocation of City staff to the Tower will result in a reallocation of a portion of the annual City Hall debt service costs from various special and capital funds to the General Fund based on the updated use of the space. Budget staff will examine options to ensure appropriate debt allocation among budgeted funds. A preliminary analysis indicates that the annual debt service allocation cost to the General Fund could range from \$275,000 to \$430,000.

At some time in the future, it may be necessary to lease space outside of City Hall to address any significant growth of City departments. There is sufficient net income from the USPTO lease after year five to address that situation if necessary, and the opportunity to take back the space for City use after 10 years.

EVALUATION AND FOLLOW-UP

After the lease agreement is signed, no follow-up action by the City Council is anticipated until the lease term expires, other than appropriation actions. Ongoing monitoring of private activity will be necessary in order to ensure that the City remains within the private activity limits. There will be additional Council actions required as the design and construction process begins.

PUBLIC OUTREACH/INTEREST

- ☒ **Criteria 1:** Requires Council action on the use of public funds equal to \$1,000,000 or greater. **(Required: Website Posting)**
- ☐ **Criteria 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- ☐ **Criteria 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

This memo meets Criteria 1 and will be posted on the City's website for the April 15, 2014 Council agenda.

COORDINATION

This memo has been coordinated with the City Attorney's Office, the Finance Department, and the City Manager's Budget Office.

FISCAL/POLICY ALIGNMENT

The project is aligned with San José's Economic Strategy, particularly Goal #1 to support Driving Industries and Goal #10 to position Downtown San José as "Silicon Valley's City Center."

This memo addresses requirements set forth in the recently adopted State of California AB 562 (Government Code 53083) for publication of information related to an economic development subsidy and a public hearing. See Appendix A for summary.

The memo is complying with Rules Rule 6.5.c3 to provide information in six required categories for projects with a public subsidy of \$1 million or more. See Appendix A for summary.

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BUDGET REFERENCE

The initial USPTO project costs of \$200,000 are funded from the Public Works Unfunded Projects appropriation as cited below.

Fund #	Appn #	Appn. Name	Total Appn	Adopted Budget (Page)	Last Budget Action (Date, Ord. No.)
001	2584	Public Works Unfunded Projects	368,000	IX-30	02/11/14 Ord. 29378

CEQA

Exempt, File No. PP14-031.

/s/

DAVE SYKES

Director, Public Works

/s/

KIM WALESH

Director of Economic Development
Chief Strategist

For questions please contact Kim Walesh, Director of Economic Development, at (408) 535-8177 or Harry Freitas, Assistant Director of Public Works, at (408) 535-8302.

Appendix A

SUMMARY OF INFORMATION RELATED TO PUBLIC SUBSIDY

I. Information Required to Comply with City of San José Rules Resolution 6.5 c3

i. Accountability	The project is structured as a Lease Agreement.
ii. Net Fiscal Impact	The project will not generate tax revenue directly, although indirectly sales tax and parking revenue will be generated by visitors to the USPTO. The project does not involve direct financial assistance, but rather less-than-market rate lease term for five years of the potentially 20 year term for space that is not currently leased or generating revenue. Over the Year 6-10 period, USPTO will be paying about \$3 million less in lease revenue compared to full market office rate.
iii. Net Job Impact	USPTO anticipates hiring 110 staff. The federal positions will range from GS-7 to GS-11. The salary range is between \$52,000 and \$91,000 depending on qualifications and previous work experience. Most staff will some level of previous work experience will start around \$70,000. Health insurance will be provided. Contract staff (administrative and IT) will be paid fair wages under the federal Service Contract Act of 1965.
iv. Housing Impact	The majority of employees will be hired from the local labor market into newly created positions. No new demand for Extremely Low Income housing units is expected to be generated by employees of this project.
v. Source of Funds	This project is not providing funds directly to the USPTO. See Memo sections "Lease Terms", "Cost Summary" and "Budget Reference" for information on anticipated City costs and revenues related to the project.
vi. Neighborhood Impacts	No significant impacts are anticipated on traffic or public infrastructure such as parks, community centers and libraries.

II. Information Required Under State Of California AB 562

i. Name/address of benefiting business entity	U.S. Patent and Trademark Office 600 Dulany Street Alexandria, VA 22314
ii. Start and end dates for the subsidy	The lease term is an initial five years beginning in 2015, with 15 years of options.
iii. Description of the subsidy, estimated total amount of expenditure of public funds or revenue lost	The project does not involve direct financial assistance, but rather less-than-market rate lease term for five years of the potentially 20 year term for a space that is not currently leased or generating revenue. Over the Years 6-10 period, USPTO will be paying about \$3 million less in lease revenue compared to full market office rate.
iv. Statement of public purpose	To secure the new satellite regional Patent and Trademark Office in Downtown San José, with the associated public benefits described in the Memo—better access to USPTO, accelerated patent processing, new jobs, additional leases nearby, new business visitors, strengthened identity.
v. Projected tax revenue	The project is a federal government office and will not generate tax revenue directly, although indirectly sales tax and parking revenue will be generated by visitors to the Patent and Trademark Office.
vi. Estimated number of jobs created, broken down by full-time, part-time and temporary positions	The project will create approximately 110 full-time positions.